# Robo-Advisors: Emerging Trends for Individual Investors

SUMMITFINANCIAL
ADVISORS, LLC

San Mateo, California | www.summit-advisors.com | contact the firm | 800-518-6686

In our rapidly changing world, traditional practices and services tend to be displaced by faster and more consumer friendly substitutes. The emergence of the online platform has facilitated this shift from "in-person" assistance to algebraically programmed, artificial management viewed through a collection of pixels displayed on a screen. Instead of picking up the phone or venturing from the house, one simply navigates a website. In as little as two minutes or a few mouse clicks, and the product or service has been requested. Insurance estimates, bank deposits, and even groceries can be delivered through online interaction with an advanced interface.

While the role of the traditional financial advisor has largely remained consistent for many decades, financial advisory services are not immune to these technological changes. An advisor meets with clients in-person, gathers valuable personal information, develops a set of recommended strategies and implements them with experienced guidance. Though this service may seem irreplaceable, online providers, so-called Robo Advisors ("RA's"), are surging in popularity. RA's offer low minimum balance requirements and cost efficient investment strategies but no interactions with a human advisor.

A critical question for investors and the providers of financial planning and investment advice concerns the future role of RA's within the financial advisory industry. Could RA's possibly replace the traditional financial advisor? This report will investigate the features of RA's, examine the obstacles they face, and then conclude that this new industry will likely carve out a growing role in future portfolio management.

## BACKGROUND

The financial services industry is comprised of brokering, financial planning, and advising services. Traditional stock brokerage transactions were the first service that the industry offered. Initially, these transactions were performed for a high, fixed cost. On May 1, 1975, based on a mandate from the Securities & Exchange Commission, the brokerage industry deregulated commissions allowing prices to be set through competitive market forces. Over time, national and local firms evolved to offer financial planning and investment advisory services to high net worth and increasingly middle class households. To varying degrees, these advisors provide holistic advice to clients, manage their accounts and customize suitable investment portfolios. These services are typically targeted toward upper middle class and high net worth clients with minimums of $500,000 or $1,000,000, and in some cases higher. These services attract high income households, those with larger account balances and/or sophisticated financial planning needs, leaving those of more modest or basic needs unmet.

Traditional advisors retain clients due to their experience, specialization, value-added services and the high value that people place on a personal, trusted relationship. Since 2010, many are surprised to learn that the amount of self-directed investors has decreased for this very reason.[1] People crave the bridge that the experienced advisors' guidance provides between their relative lack of knowledge and effective money management. However, a friction exists in the relationship between the advisor and the client. These include what method of compensation is utilized (fees or commissions), whether the advisor's recommendations are influenced by a captive or conflicting relationship or if the advisor is acting in a fiduciary or sales capacity. For these reasons, a mismatch in the client's expectations or loss of confidence could lead to abandoning traditional advice for other options. Finally, individualized personal financial planning and robust investment advice is not an inexpensive endeavor. Given the relative high costs of quality advice, investors may seek lower cost options, even at the expense of a more personalized approach.

In the last 20 years, investment services further evolved with the development of online trading and investment platforms, which deliver transactional investment management to all wealth categories. Because they limit human interaction, these services are offered at a lower cost and for smaller portfolio sizes. While not quite investment

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[1] The Wall Street Journal. "Can Robo Advisers Replace Human Financial Advisers?" *The Wall Street Journal.* 28 Feb. 2016

advisory or financial planning, instead they focus on efficiently executing transactions and turnkey asset management programs.  More recently, the progression and advancement of online investment platforms, websites and mobile applications have evolved into the present "Robo-Advisor~~s~~"model.  Requiring no human interaction, RA's attempt to deliver investment management, automated portfolio design and rebalancing at a lower cost than traditional approaches.

## BRING ON THE ROBOTS

Enter Robo Advising, a cheaper, online advisory service that aims to serve and attract less affluent demographics.  When applying for RA services, a prospective customer would fill out an online questionnaire, allowing the software to create a portfolio based on the applicant's income, risk tendencies, and future goals.  RA's automatically allocate the portfolio across different asset classes utilizing lower cost, passive strategies thus reducing costs for investors.

Wealthfront, a completely automated RA company, currently leads the industry with roughly 30% in market share and $3.5 billion in assets under management.  Its questionnaire, comprised of 7 questions, attempts to gauge an investor's risk tolerance based on their income level and goals for management of the portfolio.  Wealthfront calculates risk tolerance using its proprietary algorithm and suggests their version of an optimal portfolio allocation.  It further promotes leading passive investment strategies as its investment choices. The entire process is simple and requires approximately 15 minutes to complete.

The combination of low fees and simplicity attracted millennials and those with smaller portfolio sizes to RA companies, thus tapping into a previously under-served demographic. The RA sphere allows less affluent investors the opportunity to begin investing and seek to grow their portfolios at low costs usually around 0.35% a year.[2] In 2015, Wealthfront reported that 90% of its 30,000 clients were under the age of 50 and 65% under the age of 35. RA firms project that customers under age 35 will ultimately commit approximately 40% of their assets to RA's.[3]

With actively managed strategies historically underperforming, some investors have shifted their focus to simply replicating market returns at lower costs. Investors can further sever their reliance on unreliable investment performance of active management by enrolling with a RA. A study put forth by AT Kearny, a global management consulting firm, found that interest in RA services is very high. Over the next 10 years, they anticipate 68% compound annual growth rate in the industry, as affluent investors, self-directed investors and new adopters begin to use these services. Furthermore, they suggest that 33% of current investors are open to having a RA as

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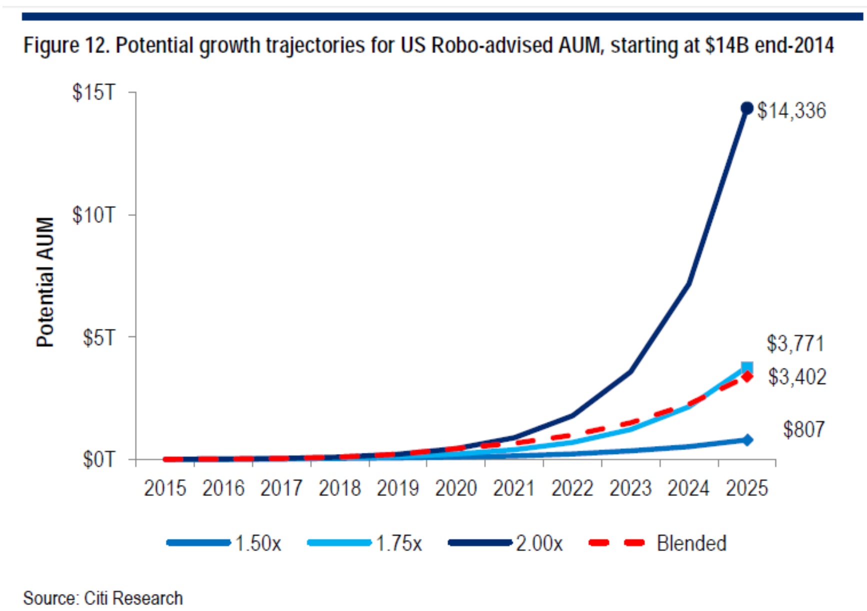
[2] Ludwig, Larry, "Betterment vs. Wealthfront - Which Robo-Advisor is Better?" 10 September 2016

[3] A.T. Kearney. "Hype vs. Reality: The Coming Waves of "Robo" Adoption." *A.T. Keaney*. June 2015

their primary financial resource.  The recent emergence of these RA's has the potential to divide the financial advisory industry into two categories: a low-cost algorithmic approach and a high-touch, personalized financial planning and investment advisory approach.

Potential Growth Trajectories for the Robo Advising Industry

[4] 


## CRITICISMS

While it seems that RAs offer a great deal of value to the investors, many have begun to question the quality of their advisory services.  Some suggest that even the name "Robo Advisor" is a misnomer because the algorithms provide no advice; merely

[4] Image from Value Walk. "Robo-Advisors AUM Could Grow To $5 Trillion In 10 Years: Citi." *Value Walk*. 3 Sept. 2015.

automated asset allocation without the use of a human financial planner.  This further prompts the question of whether RA's can maintain an investment fiduciary responsibility to their clients.  Looking to address this dilemma, the Massachusetts Securities Division complied a report that estimated that RA firms would reach $470 billion in assets under management by 2020, but also critiqued the inability for leading companies to maintain fiduciary responsibility.[5]  The report pointed out three critical flaws that RA firms need to address more thoroughly.  The first is the risk questionnaire's lack of depth and detail when gauging a prospective client's risk tolerance.  Next, it argues that a lack of human interaction undercuts the investment process and likely results in less than optimal performance.  Finally, it highlight that the algorithm investment approach lacks customization and instead offers all investors the same, passive, investment strategies.

Melanie L. Fein, the former senior counsel to the board of governors of the Federal Reserve, seconds the assertion that RA's do not maintain fiduciary responsibility.  She states that RA's questionnaires do not acquire enough necessary information to make effective wealth management decisions.  In fact, Fein argues that they leave out vital pieces of information, like withdrawal schedules, dependents involved, the possibility of major future purchases, and the impact of changing interest rates.  As for asset allocation, Fein argues that RA's may not consistently outperform active managers

[5] Massachusetts Secretary of State. "Policy: ROBO-ADVISERS AND STATE INVESTMENT ADVISER REGISTRATION."

because they retain different interests from their investors.  Furthermore, personal consultations are only available for investors with over $500,000 in assets on a one-time basis — clearly inadequate to address the myriad of critical inputs into the investment advisory process.

Of course, the classic argument against RA's still stands; the guidance and personalization of a competent, experienced advisor cannot be replicated through online platforms.  Many consumers place a high value on the benefits of an ongoing planning process; helping investors battle psychological bias' and tendencies that can lead to poor decisions.  Advisors can coordinate investment advice with genuine risk management, financing questions, handling employee stock options, tax & estate planning, et al.

## ADVANTAGES

Nonetheless, RA's offer some advantages over more traditional financial advisors.  First, they minimize human error as both investment managers and clients have cognitive biases such as overconfidence.  Rationalizing our actions (or inaction) and hubris, the excessive pride that led to the downfall of humans in many Greek tragedies, can lead to poor decision-making.  Next, they provide an opportunity for many new who want to avoid high fees and are reluctant to discuss personal finances "affordable anonymity" to initiate an investing program.  Finally, many RA firms' offer a standardized approach that can work for basic circumstances which will be appropriate for some consumers.

## A THIRD OPTION

We expect RA services to occupy a significant, and growing, space in the financial industry and compete effectively against traditional financial advisory services. Because traditional financial advisors may fail to address less affluent clientele, RA's with their lower cost structure, have the opportunity to gain market share rapidly.  In the face of these technological improvements, another significant segment of the advisory industry will certainly make its case; the independent financial advisors. Therefore, we expect the industry to be segmented into three distinct approaches, each offering a unique relationship for investors to consider centered around a central question; what do you value in an "advisor"?

### Traditional Financial Advisors

Many investors, especially those less interested in a technology-based offering, will likely maintain their more traditional relationships with established purveyors of investment services.  They offer established brands and a "Supermarket of Services" which can meet the needs of many households despite being hampered by an advisors captive relationship to their employers and relatively high costs.

## **Robo Advisors**

The upstarts offer convenience and low costs through a technology-centered approach. For those with smaller account sizes, an orientation toward online offerings, lower cost programs or an appreciation for a strictly passive investment approach, these new offerings will be attractive. However, for many consumers who are looking for the experienced advice, a customized approach, coordinated financial planning advice or a wider range of investment strategies, they will find these types of products lacking in breadth and depth.

## **Independent Financial Advisors**

Independent Financial Advisors have carved out an increasing percentage of the assets under management in the advisory industry. This has been accomplished by featuring independent, coordinated, personalized investment and financial planning advice and competitive costs. Many are integrating technology-oriented strategies into their offerings, as a way to deliver more breadth, at lower cost to an increasing number of household portfolio sizes. Today, not all firms have technology-driven offerings and even more have cost prohibitive annual fee thresholds or high minimum balance requirements keeping them out of reach for some investors.

## CONCLUSIONS

Whether investors engage with the asset allocation services of RA's, the independent and comprehensive offerings of independent financial advisors or maintain long-standing relationships with more traditional firms, they are likely to enjoy two important benefits moving forward.

1. Investors now have many more choices available at all portfolio sizes.  For years, investors with portfolio sizes of $5,000,000+ have had access to the full range of investment choices, comprehensive financial planning services and better technology in seeking to increase strategy discipline, minimize the impact of taxes while attempting to improve investment performance.  Today, for those looking for an investment or asset allocation strategy, the new online offerings can deliver that for balances as low as $5,000.

2. Investors are benefitting from lower costs.  The costs up-and-down the investment process such as commissions, advisory fees, and fees for complimentary planning services are falling.  When investors prefer passive versus active forms of management, asset management expenses are lower. New entrants, like the robo-advisors, have increased the number of services and lowered the prices of the offerings by applying new technologies.

Summit Financial Advisors, LLC is a SEC Registered Investment Adviser providing private account and wealth management services to clients in the San Francisco Bay Area and across the country.  Founded in 1998, the firm combines a total wealth management approach to financial planning strategies with a disciplined asset management program.

Focused exclusively on building and preserving wealth, they deliver a disciplined approach including portfolio management, generating retirement income, minimizing income taxes and risk management.  It's mission is to be the single resource for comprehensive wealth management.

The SF Portfolio Strategies are one of their comprehensive approaches for disciplined investing.  In an effort to minimize costs and generate better performance, the program provides for a sophisticated, automated and technology-based experience.

Rafael O. Velez, AIF® is the Managing Director, Chief Compliance Officer, Co-Founder and an Investment Adviser.  He holds a B.S. from Menlo College and the Accredited Investment Fiduciary® designation, which is associated with Katz, School of Business at The University of Pittsburg.

Mark B. Pietrofesa, CFP® is the Co-Founder and an Investment Adviser.  He holds a B.S. from The University of Minnesota, has earned the Certified Financial Planner™ designation and is a member of the Financial Planning Association.

You can learn more about us at:
www.summit-advisors.com
800-518-6686

109 Baldwin Avenue
San Mateo, California 94401

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